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IN THE

Supreme Court of the United States

OCTOBER TERM, 1940.

No. 444.

In the Matter of
CONSOLIDATED ROCK PRODUCTS CO., a Delaware corporation,
Debtor,

UNION ROCK COMPANY, a corporation,
Subsidiary,

and

CONSUMERS ROCK & GRAVEL COMPANY, INC., a corporation,
Subsidiary.

F. B. BADGLEY, COLONEL R. E. FRITH, T. FENTON KNIGHT, and WALTER S. TAYLOR, composing the Union Rock Company Bondholders' Protective Committee; and WM. D. COURTRIGHT, FRED L. DREHER, F. J. GAY and GUY WITTER, composing the Consumers Rock & Gravel Company, Inc. Bondholders' Protective Committee,
Petitioners,

vs.

E. BLOIS DU BOIS,
Respondent.

BRIEF FOR PETITIONERS.

Statement of Facts and Outline of Proceedings Below.

Consolidated Rock Products Co. (hereinafter called "Consolidated") has no outstanding securities except preferred and common stock. This stock was sold publicly in 1929 and most of the proceeds used to purchase all of the outstanding stocks of Consumers Rock & Gravel Company, Inc. (hereinafter called "Consumers") and Union

Rock Company (hereinafter called "Union"). Prior thereto Consumers and Union had been separate, competing, independently owned and operated, and unaffiliated companies engaged in the rock, sand and gravel business in the Los Angeles area [R. 132-136, 233, 234].

The properties of Union were subject to a bond issue sold to the public in 1927. The properties of Consumers were subject to a bond issue sold to the public in 1928 [R. 134, 235].

After Consumers and Union became wholly-owned subsidiaries of Consolidated in 1929, instead of merging or consolidating, the parent company operated its subsidiaries pursuant to a so-called operating agreement by which the parent took over all current assets and assumed all current liabilities of the subsidiaries and was given the right to operate their respective properties, paying them sufficient to service their bond issues and to offset depreciation [R. 137-141, 236, 237].

With the balance of the proceeds received from the sale of its preferred and common stock not used to purchase the stock of Union and Consumers, Consolidated acquired certain properties of its own [R. 139].

All of the properties involved were operated by Consolidated as a unit. The use of the names of Union and Consumers in the business was discontinued. To all intents and purposes it was all Consolidated business and they were all Consolidated properties. The personal property, machinery, crushers, trucks and other equipment, became so commingled in the course of years of this unified operation that it would be impossible accurately to identify and segregate these properties of each of the companies [R. 150, 279].

In 1935, defaults having occurred in principal, sinking fund and interest payments due on the subsidiaries' bonds, Consolidated petitioned the District Court for reorganization under Section 77B of the Bankruptcy Act. The subsidiaries did likewise, and all asked that their properties be reorganized together [R. 145, 241, 267].

Consumers bondholders organized a Protective Committee (hereinafter called the "Consumers Committee"). Union bondholders also formed a Protective Committee (hereinafter called the "Union Committee"). These Committees are the petitioners herein.

After almost two years of negotiations between the Bondholders' Committees and Consolidated, a Plan of Reorganization was agreed upon in 1937 and approved by the holders of two-thirds of the Union bonds, two-thirds of the Consumers bonds, and a majority of each class of stock of Consolidated [R. 259, 270].

The Plan provides for the transfer of the properties of all the companies to a New Company which is to issue new Bonds secured by a blanket mortgage on all the properties, New Preferred Stock and New Common Stock [R. 26-33].

The bondholders of Union and Consumers are to receive for each $1,000 bond: (a) $500 in New Bonds, (b) $500 in New Preferred Stock, and (c) warrants or options for the purchase of New Common Stock [R. 28, 29].

The preferred stockholders of Consolidated are to receive New Common Stock on a share for share basis. The common stockholders of Consolidated are to receive only warrants or options to purchase New Common Stock [R. 31].

One of three objectors to the Plan was E. Blois du Bois, respondent herein, who owned $150,000 of Union bonds (out of a total of $1,979,500 outstanding) and $31,500 of Consumers bonds (out of a total of $1,200,500 outstanding), most of which had been purchased after default or after the commencement of the reorganization proceeding at prices ranging from 14½¢ to 21¢ on the dollar [R. 156, 157, 246].

The District Court referred the Plan to a special master, who after an extensive hearing recommended its approval [R. 129-159]. After argument on the master's report, the District Court filed its memorandum of conclusions on August 8, 1938 [R. 219-230] directing preparation of a formal decree, which was filed September 8, 1938, confirming the Plan [R. 231-265].

Du Bois, the objecting bondholder, appealed to the Circuit Court of Appeals for the Ninth Circuit on November 4, 1939, and that court rendered its opinion, with one dissent, affirming the decision of the District Court. This opinion is reported in 107 Fed. (2d) 96 (Advance Sheets). Two days later on November 6, 1939, this Court decided the case of *Case v. Los Angeles Lumber Products Co., Ltd.*, 308 U. S. 106 (hereinafter called the *"Los Angeles Lumber Products* case"). Du Bois petitioned the Circuit Court of Appeals for a rehearing. The Securities and Exchange Commission (hereinafter called the "S. E. C.") filed an *amicus* brief, urging that the petition be granted. The petition was granted, and the opinion of November 4, 1939, was withdrawn. Additional briefs were filed, and on June 19, 1940, the Circuit Court of Appeals, reversing its own previous position, rendered its decision (reported

at 114 Fed. (2d) 102 (Advance Sheets)) reversing the decree of the District Court which had confirmed the Plan.

The Circuit Court of Appeals finally held, on the authority of the *Los Angeles Lumber Products* case, that the Plan is unfair as a matter of law because it denies full priority to the claims of the Union and Consumers bondholders respectively, and further that such priority is denied because under the Plan both classes of bondholders are to be given: (a) bonds secured by a blanket mortgage on all the properties (instead of separate issues of bonds secured by the same properties that secure the present bonds), and (b) preferred stock in a New Company which will own all the properties.

Prior to July 19, 1940, all parties to the appeal (including du Bois) joined in a motion to the Circuit Court of Appeals to modify its opinion in so far as the latter ground is concerned (*i. e.*, that priority is denied the bondholders because they are offered bonds secured by a blanket mortgage on the combined properties instead of by separate mortgages on the respective properties). The S. E. C. recommended the granting of this motion. This motion, however, was denied, although a motion to correct the opinion on minor points was granted.

Consolidated and its two subsidiaries and a committee of preferred stockholders of Consolidated then petitioned for a rehearing, which was denied on August 5, 1940.

Consolidated and the Consolidated Preferred Stockholders' Committee then petitioned this Court for a writ of certiorari, which was granted on October 28, 1940, in Case No. 400.

The two Bondholders' Committees, petitioners herein, also petitioned this Court for a writ of certiorari, but on

the limited ground that the decision of the Circuit Court of Appeals was erroneous as a matter of law in so far as it holds that the "full priority" rule requires that each class of bondholders be given New Bonds secured by the properties originally securing them, instead of giving both classes of bondholders New Bonds secured by a blanket mortgage on the combined properties. The S. E. C. and the Interstate Commerce Commission filed *amicus* memoranda recommending that the Bondholders' Committees' petition be granted and that the petition of Consolidated and the Consolidated Preferred Stockholders' Committee in Case No. 400 be granted in so far as the latter presents the same question which is presented by the petition herein.

The Bondholders' Committees' petition herein was granted on October 28, 1940.

Jurisdiction.

The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

Statute Involved.

The statute involved is Section 77B (f) of the Bankruptcy Act (11 U. S. C., Sec. 207 (f)), the pertinent portion of which is as follows:

> "After hearing such objections as may be made to the plan the judge shall confirm the plan if satisfied that (1) it is fair and equitable and does not discriminate unfairly in favor of any class of creditors or stockholders, and is feasible * * *."

Question Involved.

The only question presented in this case (No. 444) is whether or not the Circuit Court of Appeals was correct as a matter of law in holding that the Plan denies full priority to the Union and Consumers bondholders merely because it provides for transferring all the properties of Consolidated, Union and Consumers to a New Company and substituting bonds of one issue secured by a blanket mortgage on all the properties for bonds of the two present issues secured, respectively, by the properties of Union and Consumers.

Meaning of Decision Below.

That the decision of the Circuit Court of Appeals presents this question is not open to doubt. The court could have limited its decision to holding that the Plan is unfair under the "full priority" rule on the ground that, although stockholders are accorded participation, the bondholders' claims to the full extent of the principal and accrued interest of their bonds are not given adequate compensation. That may have been the meaning that the court intended to convey, but the language used seems clearly to go further and state that full priority is denied the Union bondholders as to the Union assets because the Consumers bondholders are given an interest in those assets, and that full priority is denied the Consumers bondholders as to the Consumers assets because the Union bondholders are given an interest in those assets. Furthermore, this point was brought to the attention of the court in the motion for modification of the court's opinion referred to above, and the motion for such modification was denied.

The exact words used by the court in its opinion are (p. 107, Advance Sheets):

> "The trial court found that the property of Union covered by the trust indenture was insufficient to pay

> the principal and accrued interest of the bonds issued by Union, yet the Union bondholders are deprived of their right to full priority against Union's assets, since Consumers' bondholders and debtor's preferred stockholders are given an interest in Union's property. Likewise, the trial court found that the property of Consumers covered by the trust indenture was insufficient to pay the principal and accrued interest of the bonds issued by Consumers, yet Consumers' bondholders are deprived of their right to full priority against Consumers' assets, since Union bondholders and debtor's preferred stockholders are given an interest in Consumers' property."

The only interest in the Union properties given to the Consumers bondholders under the Plan, and the only interest in the Consumers properties given to Union bondholders, result from the provision that all of the properties of the Debtor and its subsidiaries are to be transferred to a New Company, the liens of the present Union and Consumers bonds are to be released, and a new blanket mortgage is to be substituted therefor which is to secure one new issue of bonds to be allocated to the old Consumers and Union bondholders in proportion to their present holdings, and from the provision that the New Preferred Stock is to be similarly allocated to the old Union and Consumers bondholders.

The court's decision, therefore, is that a plan of reorganization involving two or more bond issues secured by liens on different properties is *per se* unfair and inequitable if it substitutes one new bond issue, secured by all of the properties, for the several old bond issues separately secured, or if it substitutes for the old bond issues, any new securities, whether part bonds and part stock, or all stock, constituting an interest in all of the properties.

Argument.

Such a decision is not good law and should be corrected by this Court.

1. It is not compelled by either the decision or the principles of law stated by this Court in the *Los Angeles Lumber Products* case. In that case the Debtor was insolvent; yet the plan allowed the old stockholders to participate in the reorganized enterprise. This Court held that the participation of the stockholders was not "based on a contribution in money or in money's worth, reasonably equivalent in view of all the circumstances to the participation of the stockholder" (p. 122). This Court held that the plan was therefore unfair and inequitable. In so holding this Court stated certain principles governing the fairness of plans of reorganization, which are not novel or revolutionary in the field of corporate reorganization, although they were certainly more completely and cogently stated in that opinion than ever before. Briefly stated, they are that secured creditors come first to the full extent of their claims, unsecured creditors second, and stockholders third; and if the assets are insufficient to satisfy any prior class in full, then no participation can be given a junior class unless a compensatory contribution is made by such junior class.

The creditors in the *Los Angeles Lumber Products* case comprised only a single class. Nowhere in the opinion in that case is there any indication that, where the creditors involved in a reorganization comprise two or more classes having separate liens on intermingled properties, the "full priority" rule requires that each class, to the exclusion of the other class or classes, receive securities

representing only a charge upon or an interest in the specific properties subject to the lien of their old securities. None of the decisions of this Court give sanction to a rule so rigid and impractical.

On the contrary, this Court recognized the importance of practicality in the application of the "fixed principle" of full priority. Circumstances alter such application. This is illustrated by the following passage from the opinion of this Court in the *Los Angeles Lumber Products* case:

> "In application of this rule of full or absolute priority this Court recognized certain practical considerations and made it clear that such rule did not 'require the impossible and make it necessary to pay an unsecured creditor in cash as a condition of stockholders retaining an interest in the reorganized company. His interest can be preserved by the issuance, on equitable terms, of income bonds or preferred stock.' Northern Pacific Ry. Co. v. Boyd, *supra*, p. 508 (228 U. S. 482). And this practical aspect of the problem was further amplified in Kansas City Terminal Ry. Co. v. Central Union Trust Co., *supra* (271 U. S. 445) by the statement that 'when necessary, they (creditors) may be protected through other arrangements which distinctly recognize their equitable right to be preferred to stockholders against the full value of all property belonging to the debtor corporation, and afford each of them fair opportunity, measured by the existing circumstances, to avail himself of this right.' (pp. 454-455)." (P. 117.)

The question in each case is: Are the new securities, regardless of their form, reasonably compensatory as to value and priority for the old securities for which they are being exchanged? In the instant case we have two bond issues, each secured by different properties. Assuming that the values of the respective properties bear the same ratio to the debts which they secure, it would seem obvious that new bonds of one issue equal in amount to the aggregate of the two old issues and secured by both properties would be reasonably compensatory (both as to value and priority) for the old bonds secured by the respective properties, and that the same would be true if the new securities were part new bonds secured by all the properties and part new preferred stock of a new company owning all the properties.

2. The holding of the Circuit Court of Appeals below is contrary to precedents which have involved similar facts.

Jameson v. Guaranty Trust Co. of New York, 20 Fed. (2d) 808 (C. C. A. 7), certiorari denied 275 U. S. 569, involved the reorganization of the Chicago, Milwaukee & St. Paul Railway Company through an equity receivership. Both the District Court and the Circuit Court of Appeals approved a reorganization plan which provided that the holders of outstanding bond issues, each secured by a lien or a particular portion of the company's properties, should participate equally in two new bond issues, a first mortgage and a second mortgage, each covering all of the properties by which the old bond issues had previously been separately secured.

This is common practice in the reorganization of traction companies and railroads. For example, in *In re United Railways & Electric Co.*, 11 Fed. Supp. 717 (D. Md.), nine different security issues, each secured by a mortgage, were supplanted by a single issue of debentures and an issue of preferred stock, both of which were securities of a single corporation holding title to all of the properties. The District Court stated:

> "There had been outstanding for many years 12 issues of securities, constituting the capitalization of the company. Of these, five were divisional bonds, and two were Maryland Electric Company bonds, which were substantially divisional bonds. Each one of these divisional bonds covered a railway which was originally an independent unit, a self-contained railway, but through the later consolidations this independent character was completely destroyed. The identity of the respective assets of each railway became lost and, therefore, it became absolutely essential to disregard the various divisions in the present reorganization, in so far as different securities were concerned, and simply to proportion, as nearly as possible, the actual values that now adhere to the respective parts, as represented by the old securities. Thus, under the reorganization, nine different mortgages with their respective securities have been supplanted by the issue of (1) debentures and (2) preferred stock." (P. 720.)

The Interstate Commerce Commission has also approved as fair and equitable a number of plans of reorganization of railroads in which the holders of bonds secured by

divisional mortgages were given general system securities of the same classes in exchange for their claims.[1]

3. If the decision of the Circuit Court of Appeals which petitioners believe to be erroneous as a matter of law, is not reversed by this Court, it may be impossible to effect a reorganization of the debtor and its subsidiaries.

The properties of Union, Consumers and Consolidated consist principally of rock, sand and gravel pits and the plants and machinery necessary for the operation thereof, such as crushers, screeners and conveyers, as well as trucks for the transportation of the product. These have been operated as a unit for more than ten years. The real properties are all distinguishable, but much of the ma-

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[1]See *Missouri-Pac. R. R. Co. Reorganization*, 239 I. C. C. 7, 240 I. C. C. 15; *Chicago & North Western Railway Co. Reorganization*, 236 I. C. C. 575, 239 I. C. C. 613, approved by the District Court for the Northern District of Illinois on September 11, 1940, C. C. H. Bankruptcy Service, Par. 52666; *Chicago, Milwaukee, St. Paul and Pacific R. Co. Reorganization*, 239 I. C. C. 485, 240 I. C. C. 257; *Savannah & Atlanta Railway Reorganization*, 224 I. C. C. 197, approved by the District Court for the Southern District of Georgia on February 5, 1938, C. C. H. Bankruptcy Service, Par. 51448, and confirmed on December 12, 1938; *Spokane International Railway Company Reorganization*, 228 I. C. C. 387, 233 I. C. C. 157, approved by the District Court for the Eastern District of Washington on March 2, 1940, C. C. H. Bankruptcy Service, Par. 52567, and confirmed on August 17, 1940; *Erie R. Co. Reorganization*, 239 I. C. C. 653, 240 I. C. C. 469; *Western Pac. R. Co. Reorganization*, 230 I. C. C. 61, 233 I. C. C. 409, 236 I. C. C. 1, approved by the District Court for the Northern District of California on August 15, 1940, C. C. H. Bankruptcy Service, Par. 52665; *New York, N. H. & H. R. Co. Reorganization*, 239 I. C. C. 337; *Akron, C. & Y. Ry. Co. and Northern O. Ry. Co. Reorganization*, 228 I. C. C. 645; *St. Louis-S. F. Ry. Co. Reorganization*, 240 I. C. C. 383; *Chicago, Rock Island & Pacific Railway Company*, Finance Docket No. 10028 (examiner's report on plan filed on September 22, 1939).

chinery and equipment is movable or is subject to replacement and in the course of operations this machinery has been transferred from one property to another or has been replaced with new machinery and equipment or with machinery and equipment from another plant, to such an extent that physical segregation would be impossible, no record having been kept of the transfers [R. 279, 280]. All of the parties, including du Bois, the respondent herein, have agreed that it is to the best interests of everyone that the properties be reorganized as a unit. The special master in his report, which was approved by the District Court, states [R. 147, 148]:

> "The evidence shows that it would be to the injury of all interested parties, including the bondholders and stockholders, if any attempt were made to segregate the properties and place them back in their original ownership, i. e., if the Union Company properties were to be returned to the Union Company, the Consumers Company properties to be returned to the Consumers Company, and the properties acquired by Consolidated to be segregated and retained by it. The evidence shows that there had been commingling of the various properties and assets, including rolling stock and other necessary equipment, during the period from 1929 to date. The operating revenue from the operations of the properties by Consolidated has been used upon all properties irrespective of the source from which it was produced. The funds secured by Consolidated from the sale of its stock and revenue acquired by Consolidated from operations of properties that Consolidated had acquired subsequent to the consolidation have been used to further the business as

a whole. All of these factors have made it practically impossible to effect a fair and equitable segregation of the properties. Added to this is the fact that the properties have for the past eight years been operated as if they were of one ownership. A going-business value and goodwill resulting from such ownership and joint operation has been created. From the foregoing I must conclude that it would be highly injurious and destructive of the best interests of the bondholders and stockholders of the various companies to attempt to do other than agree upon a plan of reorganization of Consolidated giving full recognition, so far as the values of the properties are concerned, to the respective interests of the bondholders and stockholders. All parties without exception at the hearing agreed that they were opposed to foreclosure and liquidation. All parties, except the objectors, were of the conviction that the plan of reorganization was the most fair, equitable and feasible to all interests that could be arrived at. All parties represented at the hearing, including the objectors (except Mr. Rogers), were convinced that a plan of reorganization which contemplated the continuance of the operation of all of the properties as one unit under one management and ownership offered the greatest assurance to the bondholders of the Union Company and the Consumers Company that they would be paid an amount approximating th par value of their bonds. Of similar opinion were the representatives of Consolidated and its stockholders, viz., that a plan of reorganization that contemplated the operation of the properties under one ownership and as one unit would undoubtedly insure the preservation for the stockholders of the equity remaining after the bondholders had been paid as provided in the plan of reorganization."

The District Court in approving the special master's report found [R. 241, 242]:

> "(a) That since the early part of 1929, and as originally contemplated and as permitted in said operating agreement, all of the business and properties of the debtor and its subsidiaries have been operated, handled and used as though there had been an actual consolidation of all thereof under one ownership.
>
> "(b) That as a result of said unified operation it would be physically impossible to determine and segregate with any degree of accuracy or fairness properties which originally belonged to the companies separately; that in many instances plants, trucks and other equipment consisting of machinery and parts originally belonging to the companies separately are now physically joined together as a piece of operating equipment; that trucks and other equipment originally belonging to one of the companies have been traded in on new equipment now owned by Consolidated Rock Products Co. and that cash, accounts receivable and materials of every character and description have been commingled and are now in the main held by Consolidated without any way of ascertaining what part, if any thereof, belongs to each or any of the companies separately."

In the light of these facts, consider the problem of formulating a plan of reorganization that would not run afoul of the decision of the court below. The present

bondholders must be given either bonds or stock, or both. If New Bonds are given, they must be secured by the same properties that secure the present bonds. But this is impossible because the properties cannot be physically segregated; *i. e.*, the personal property, machinery and equipment. If "impossible" is too strong a term, assume that the Union and Consumers properties could be identified. Then to comply with the holding, the New Bonds would have to be equal in amount to the old bonds. But this would be hardly feasible. The companies are in reorganization because of their inability to carry the present indebtedness. Yet if part bonds and part stock are given in exchange for each old bond, the only way to avoid the mandate of the court below would be to keep the identity of each of the present subsidiaries. This certainly would be unwise in view of their past unified operation and the evident desirability of continuing that operation. There would be the added complication of working out a fair participation for the present bondholders in the assets of the parent company. The result would be anything but simple.

We are confronted here with a case in which three companies have been scrambled physically without having been scrambled legally—a *de facto* omelette without *de jure* form. The reorganization proceeding offers the logical opportunity for simplifying the corporate and capital structures. We cannot and do not believe that this Court by anything said in its opinion in the *Los Angeles Lumber Products* case intended to make it impossible or impracticable to attain this desirable objective.

Conclusion.

Petitioners therefore contend that the decision of the Circuit Court of Appeals should be reversed in so far as it holds that a denial of full priority to the respective classes of bondholders results merely from the proposal that they be given New Bonds secured by a mortgage on all of the properties, and New Preferred Stock of a New Company which will own all of the properties.

In this connection it may be pointed out that the District Court found (1) that the value of all the properties exceeds the principal of and the accrued interest on the bonds affected by the Plan [R. 245], and (2) that an appraisal would be of no value to the court and result in unnecessary delay and expense [R. 255]. The record shows ample evidence to support these findings.[2] Unless this Court should determine to reinstate the decision of the District Court confirming the Plan, it would facilitate the reorganization proceeding below and the formulation of a new plan, to the best interests of all the security holders affected, if this Court were to indicate that on the state of the record no appraisal is necessary and would further

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[2]Testimony of Robert Mitchell [R. 281, 282]; testimony of Frank Gautier [R. 290]; testimony of T. C. Rogers [R. 291, 292]; testimony of Graham L. Sterling, Jr. [R. 274, 275]. It should be noted that witnesses Mitchell and Gautier testified to the value of the respective companies' properties, "taking the plants as they are", *i. e.*, on the assumption that all of the machinery and equipment located on land owned or leased by Union belongs to Union, and on the same assumption as to the plants of the other companies.

point out the respects in which it holds the Plan to deny full priority to the claims of the bondholders.

Respectfully submitted,

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